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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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DOW'S THEORY Often, when I read some flip comment about Dow's Theory (usually written by a Wall Street "name analyst"), I wonder about the critic himself and how he might compare in ability and intelligence with those who founded the Theory.

Dow's Theory has evolved from a careful study of the price movements beginning in 1896 and lasting to the present. Perhaps 90% of the Theory was developed between 1900 and 1939 through the efforts of three men; Dow, Hamilton and Rhea.

Dow's original observations stand as the pillars of the Theory, and to him must go the greatest credit. "In the history of market thought," writes George Bishop, Dow's biographer, "his place is of similar importance to that of Adam Smith in the field of economics."

Hamilton enlarged upon Dow's original principles and observations, and the Hamilton editorials which appeared in Barron's and the Wall Street Journal made the Theory famous. Hamilton's obituary appeared in the Journal on December 10, 1929, two months after he had called the turn of the great 1921-29 bull market. His death, stated the Journal, "...leaves a wide vacancy in the journalism of a continent."

Robert Rhea organized Hamilton's work, added to it and fashioned the Theory into a working investment tool. Little of real importance has been added to the Theory since Rhea's death on November 6, 1939. Professor Warren Raeder of the University of Colorado wrote Rhea's obituary in Barron's (November 13, 1939). "If his interests had been in pure or applied science," wrote Raeder, "his name would have been preserved with that of Edison, Marconi, Compton and others."

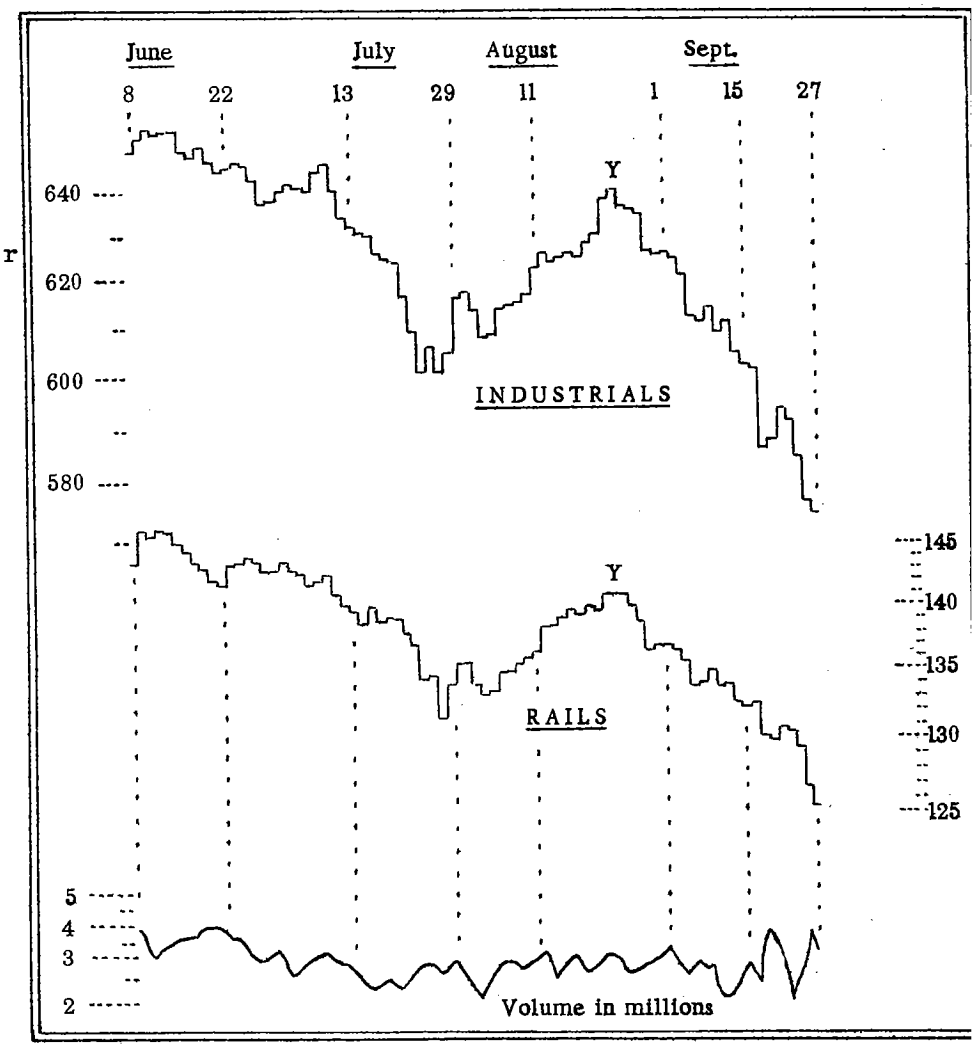
Serious students today realize that there are many new and useful things to be learned about the market. Much new technical data is now available, and we have many more years on the record with which to work. The history of the stock market is a story of bull and bear swings, secondary reactions, rallies, depressions and booms. And although all market history follows similar patterns, none of it is identical except perhaps the ever-present quality of human ignorance.

THE MARKET From March 8, 1960, to September 18, 1960, the Averages fluctuated within the area bordered by the bear market lows and the secondary reaction highs. I have often called attention to the difficulty in "reading" both volume and price indications within this so-called "secondary territory". On September 19 Industrials confirmed the bearish action of the Rails. Since then the market has been establishing successive new lows in what might be termed "primary territory". Volume and price movements since September 19 have become noticably easier to interpret. In classic bear market fashion, volume has tended to grow dull with higher prices while on declining days volume has expanded to some of the heaviest totals in many months.

As I read the signals, the first psychological phase of the bear market has about ended, and we are now entering the second phase. During the first phase of a bear market stocks are sold by informed investors who sense that business is near, but not yet at, a major turning point. In this early phase stocks sell minus the "new era" price tags which characterized the previous bull market's final speculative phase. The second (and generally longest) phase of a bear market sees stocks decline in response to obviously worsening business conditions and shrinking corporate profits. This phase is typified by occasional broad panics and collapses in individual shares. If the third phase runs true to form, it will be marked by distress selling and the retreat of many prime equities below known values. In the third or final bear phase investors liquidate the "blue chip" stocks because they need to raise cash and because there is little or no market for the

poorer grade issues.

Not to be confused with the psychological phases are the actual primary price movements or legs. The first primary leg of the bear market terminated at 616.45 for Industrials (September 22, 1959). The second primary bear leg terminated for Industrials at 599.10 (March 8, 1960). In past Letters I have mentioned that no bull or bear markets are exactly alike, and certainly the fact that the second bear leg ended only 17.35 points below the first was an unusual occurrence when judged against historical precedent.



The third primary leg began for Industrials at 656.42 (June 9). As of this writing the third leg has progressed to a level about 25 points below the termination point of the second leg (599.10). A principle of Dow's Theory states that neither the duration nor extent of a primary movement can be predicted in advance, and the unexpected shallowness of the secondary primary leg points up the wisdom of this dictum. While the current (third) leg might also turn out to be sub-normal in extent, there remains the possibility that it will do the unexpected and progress further than anyone foresees at this time. The latter is particularly feasible in view of the fact that a majority of analysts are now talking of a "major base at 550". In the current issue of U.S. News and World Report five experts voice their market opinion. None of the five foresee any great danger in the period ahead.

Earlier in the year investors were treated to a number of newspaper "debates" concerning whether this was a reaction, a decline, a "healthy shakeout" or a bear market. The arguments are harder to find today. "To the man who has been cleaned out", wrote Rhea in 1937, "the question is an academic one. It really makes no difference to the man who walked in front of a train and lost his legs whether the train was going East or West."

CONCLUSION. All three trends, primary, secondary and minor, are pointing down. The market had declined 18 out of the last 23 trading days since the August highs (or 78% of the time). In view of this, a sharp rally could make its appearance at any time.

HOW? "How," I am asked, "could a bear market have started; what has caused it?" My answer is admittedly naive. It is that the baloon went up too high, and it is now returning to earth. Yet over the last few months, perhaps a hundred people have taken the trouble to tell me that "the Government couldn't afford to let anything happen -- particularly in an election year." It has been my personal opinion that (1) something very definitely was happening, (2) the Government, unfortunately did not realize that it was happening, and (3) the Government could not stop it even if they knew it was happening. The Government cannot make a man buy another home; it cannot liquidate auto inventories; it cannot cause a housewife to buy a second electric toaster.

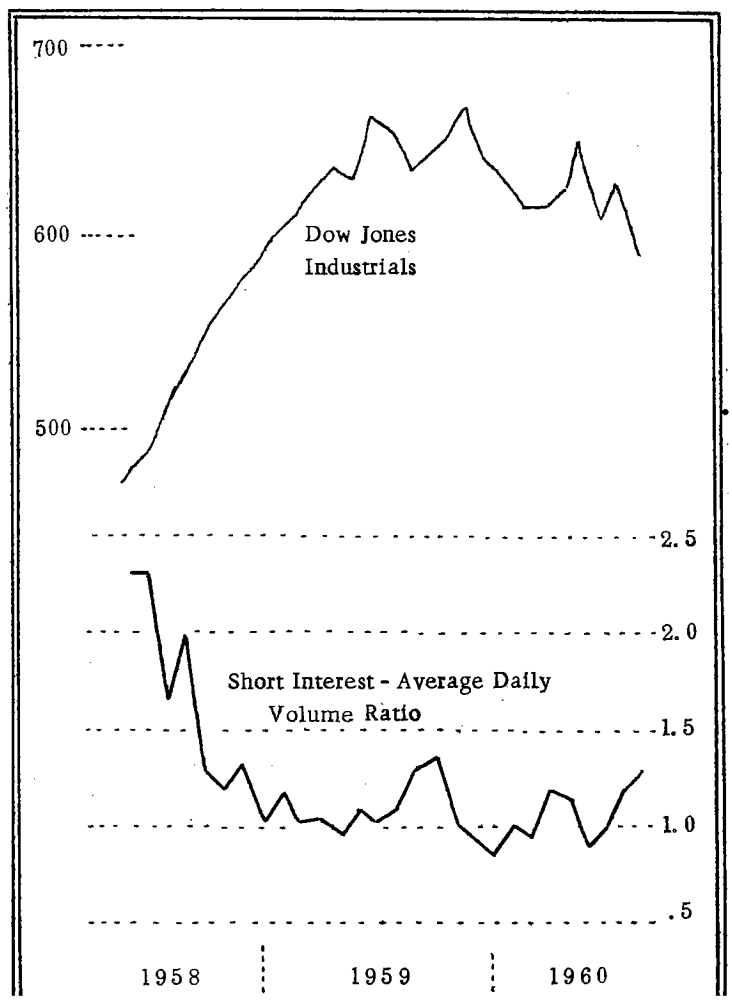
In previous Letters I have taken up the question of the colossal debt which now smothers the Government, the states, the municipalities, the cities, the corporations and the consumer. I have mentioned the gold outflow and the imbalance of payments. I have discussed the great amount of speculation in land, homes, stocks, syndications, ice cream parlors, bowling allies and what have you. With it all, I can only guess at the reasons for the primary trend's turning down, but I do know that the real reasons will be documented by the economists (as they always are) after the event.

It might also be said that the reasons change with each bear market. Thus, while economists are examining one area the trouble emerges from another. In 1907 the nation experienced a money and liquidity crisis. In 1920 money was available, but commodities collapsed. In 1929 commodities were reasonably priced, but inflated values in the stock market and low margins triggered the "crash". In 1937 inventories proved to be the culprit. In 1947 psychology itself "gave out". The list extends back through history, but history is written (except by the Averages) in hindsight.

SHORT INTEREST RATIO (S.I. Ratio) One of the indicators which I watch carefully is the ratio of the total monthly short interest to the average daily volume over the same monthly period. Although this indicator is less important in the early stages of a primary bear market, it often provides clues as to when (and whether) the market is "over-sold" and ready for an extended rally. Later in the cycle, the S.I. Ratio can be useful in calling the turn from bear to bull market.

Every short seller hopes for one of those broad, sweeping downward movements accompanied by heavy or liquidating volume. When too many shorts get on the bandwagon and when volume begins to dry up (preferably as prices hold), the implication is that the market is gathering strength. The S.I. Ratio will climb if (1) average volume drops, (2) the short interest rises. In general, it is a hopeful sign when the S.I. Ratio rises above the 1.5 level. A move by the Ratio above 2.0 is considered to be extremely bullish. If or when the latter occurs, I would not want to be caught on the short side of the market.

Last month the short interest was 3.6 million shares while average daily volume was 2.8 million shares. This means that the S.I. Ratio was 1.29, a slight rise from the previous month's 1.21. The latest 1.29 figure, however, cannot be considered a bullish factor in the current technical picture.



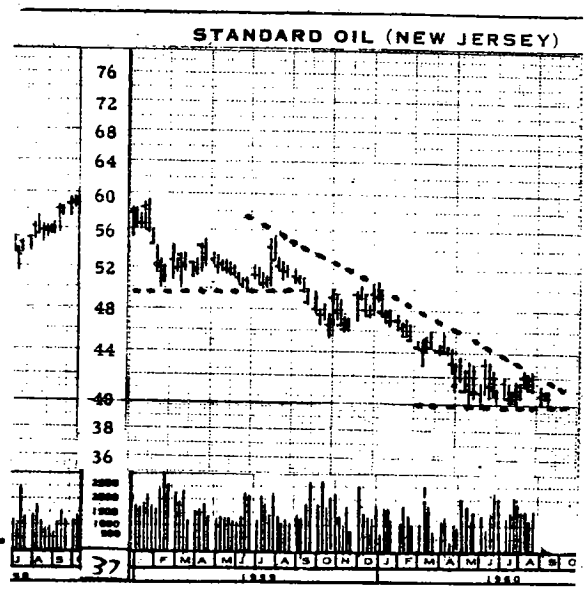
STOCKS Most of the earlier suggestions regarding "puts" and shorts have worked out fairly well. Thus a Lt. General in the Air Force (overseas) wrote this week: "You obviously get a lot of heckling mail, so I thought it might cheer you to hear that I sold my puts, which were selected from a list of your selections six months back, at a net profit of $3,000.00 on a hazard of $5,700.00. My broker in Chicago, who works in a house in which a put is a strange thing, was so excited that he called me long distance to tell me the prices I received." Which proves that even bear markets can be profitable.

A number of subscribers have asked me what I did with my own family's funds during the bear market. The largest percentage of our funds are in Treasury bills with perhaps 6-8% of it in puts or shorts. Most of the puts and

shorts are now on the profit side of the ledger, and I have added a few extra puts from time to time.

The steels (which were recommended as shorts in March) continue to look poor. The weekly chart of Bethlehem Steel (BS) is typical. After "topping" in early 1959, BS has formed a giant "head-and-shoulders top" on the weekly chart and appears to be headed lower. This huge formation is not even visable on a daily chart. I would guess that BS 's dividend could be in jeopardy. Other weak steels are Jones and Laughlin, Republic, U.S., Wheeling.

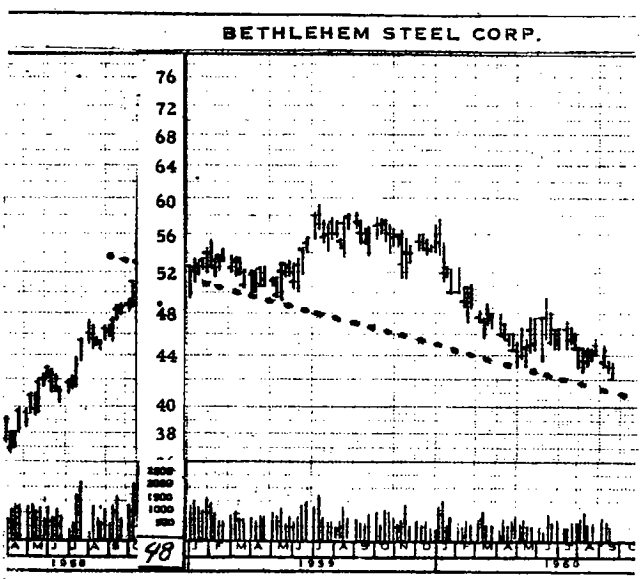
Standard of Jersey (J) seems to like the even numbers. After breaking the "50 support" (see chart) last year, Jersey has decided to make a stand at the "40 line". It has been holding there like grim death for the last five months. The weekly chart suggests distribution, but the proof won't come until J cracks 40. At that point I would think it was an interesting short.

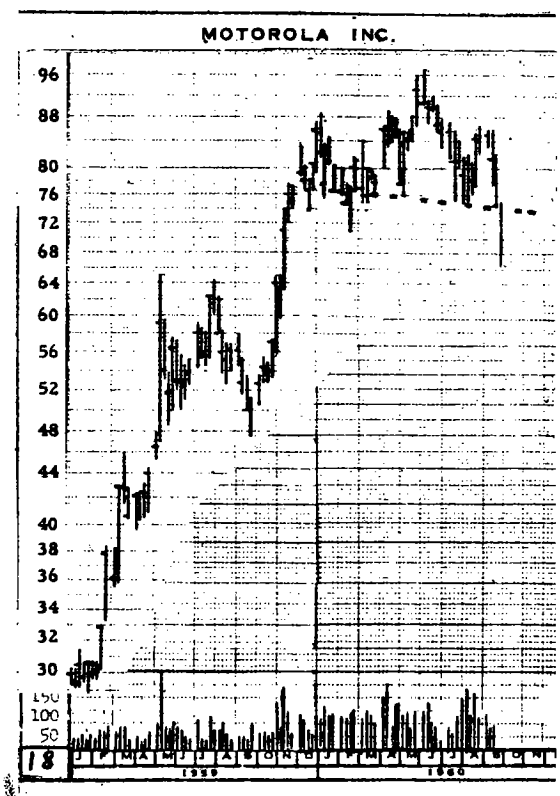


Motorola, one of the "glamour stocks" has recently broken a large "head-and-shoulders" formation. The stock should be a short on any rally back to or near 72. MOT's chart is typical of the electronic group at this time.

NOTICE Readers may be interested in the writer's article in the current (September 26) issue of Barron's. The magazine is now on the newstands.

(Written, Wednesday, September 28th - 1 P.M.)





All charts courtesy of Traders Research Inc., P. O. Box 6185 Lambert Airport, Mo.